IN THE

United States Court of Appeals

For the Ninth Circuit

WESTERN TERMINAL COMPANY,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

No. 22387

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DICTRICT COURT FOR THE EASTERN DISTRICT OF WASHINGTON

REPLY BRIEF FOR THE TAXPAYER-APPELLANT

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This Brief is submitted by the Taxpayer-Appellant in reply to the portion of the Government's Brief which relates to the points argued in the Taxpayer's Brief and in answer to the additional points argued by the Government in its Brief.

A. THE USE OF "HINDSIGHT EVIDENCE".

In its Brief, the Government states that "for purposes of this appeal, the Government will not urge the propriety of the use of any evidence not known to, or reasonably knowable by, taxpayer as of the end of the year 1960—

the tax year here in issue." (Appellee's Brief, p. 15, fn. 4) The effect of this concession is to make inadmissible almost the entire testimony of Col. Morefield (II-R.230-242) since by his own admission he was not even associated with the Air Force Fuel Supply Center until August of 1964 (II-R.230). Moreover, none of the questions directed to him were based on facts known to, or reasonably knowable by, the taxpayer at the end of 1960. A similar disqualification applies in regard to much of the testimony of Francis J. DeFavio (II-R.124-175) since most of his testimony has to do with facts occurring after 1960 and consequently with opinions based on the use of hindsight evidence. As regards the testimony of these witnesses the only really significant fact established by them was that the Air Force had only a five year forward projection as to its fuel storage needs at any given facility (II-R.239).

The Taxpayer-Appellant contends that the admitted reliance of the lower Court on evidence which was not known to, or knowable by, the Taxpayer in 1960 constitutes reversable error and justifies the remand of this case to the lower Court.[1]

B. THE "REASONABLE CERTAINTY" TEST.

In its Brief (Brief for Appellee, p. 8, 14, 15) the Gov-

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[1] The attention of the Court should be directed to the second to the last paragraph and the next to the last paragraph of the Government's Statement appearing on page 5 of its Brief, and the first full paragraph of the Government's Statement appearing on page 7 of its Brief. All three of these paragraphs require the use of hindsight evidence and should therefore be deleted from the Statement of Fact.

ernment states that the Taxpayer had the burden of proving by a preponderance of the evidence that it was "reasonably certain" that its fuel storage facility would be used by the Government for a period of 20 years. This statement is to be contrasted with the contention of the Taxpayer that it was only required to support its 1960 estimate of the useful life of its fuel storage facility by a preponderance of the evidence (Brief for Appellant, p. 37).

As regards these divergent views, the United States Supreme Court, some 37 years ago, held that a taxpayer need prove the reasonableness of its claim for obsolescence (or depreciation) by "such weight of evidence as would support a verdict for a Plaintiff in an ordinary action for money" *Burnett v. Niagara Falls Brewing Co.* 282 U.S. 648 (1931). In so holding, the Supreme Court stated

> "It would be unreasonable and violate that canon of construction to put upon a taxpayer the burden of proving to a reasonable certainty the existence and amount of obsolescence."
>
> *Burnett v. Niagara Falls Brewing Co.,* supra at 650.

And still later the Supreme Court stated

> "Neither the cost of obsolescence *nor of accruing exhaustion, wear and tear* that is properly chargeable in any period of time can be measured accurately. A *reasonable approximation* of the amount that fairly may be included in the accounts of any year is all that is required." [emphasis added] *Burnett v. Niagara Falls Brewing Co.,* supra at 650.

The above quoted reference to a "reasonable approxima-

tion" as a test for obsolescence is similar to the earlier statement of the Supreme Court in *United States v. Ludey,* 274 U.S. 295 (1927) that a depreciation allowance must be made, even though the computation was based on a "rough estimate".

Furthermore, as regard the issue of the degree of proof required of a taxpayer, while it is true that the Commissioner's Regulations state that as to *intangible assets* depreciation is to be allowed only in those cases where the length of use can be estimated with "reasonable accuracy". Treas. Reg. 1.167(a)-3 (26 C.F.R. Sec. 1.167), and that several courts have held that radio and television broadcasting rights and licenses constitute non-depreciable assets by reason of the inability of the owners thereof to establish a definite useful life for such assets. *Westinghouse Broadcasting Co. v. Commissioner,* 309 F.2d 279 (C.A. 3, 1962) cert. denied 372 U.S. 935; *Indiana Broadcasting Corporation v. Commissioner,* 350 F.2d 380 (C.A. 7, 1965) cert. denied 382 U.S. 1027; *Richmond Television Corp. v. United States,* 345 F.2d 410 (C.A. 4, 1966); but cf. *Commonwealth Natural Gas Corporation v. United States* ——F.2d—— (C.A. 4, 1968) 68-1 U.S.T.C. 9391; *Northern Natural Gas Company, v. O'Malley,* 277 F.2d 128 (C.A. 8, 1960) and *Birmingham News Co. v. Patterson,* 24 F.Supp. 670 (D.C. Ala. 1964) aff'd. 345 F.2d 531, it should be noted that the immediately preceding regulation, which relates to *tangible property,* contains nothing to indicate that a smiliar degree of proof is required as to this type of property. Treas. Reg.

1.167 (a)-2 (26 C.F.R. 1.167). Rather, the more general regulation entitled "useful life" indicates that for purposes of estimating the useful life of any given depreciable asset a taxpayer should consider "his experience with similar property taking into account present conditions and probable future developments". Treas. Reg. 1.167 (a)-1(b) (26 C.F.R. 1.167). This is exactly what was done by the Taxpayer in the instant case as is evidenced by the testimony of its two principal officers. (II-R.39-123, 177-216); see also the comment of the lower Court. (II-R. 246-248).

Refining the legal issues even more closely, the Government's reliance upon the "reasonable certainty" test appears to be taken from the language of an opinion of the Court of Appeals for the Ninth Circuit rendered some 40 years ago, see, *Lassen Lumber and Box Co. v. Blair,* 27 F.2d 17 (C.A. 9, 1928), and repeated more recently by the United States Tax Court in one of its memorandum opinions, see, *Gordon Lubricating Co. v. Commissioner,* 24 T.C.M. 697 (1965). Taxpayer's argument, on the other hand, is based upon the forthright rejection of the "reasonable certainty" test in *Burnett v. Niagara Falls Brewing Co.*, supra., and by the apparent acquiescence in the result of that case by the Court of Appeals for the Ninth Circuit in *Moise v. Burnett,* 52 F.2d 1071 (C.A. 9, 1931); See 120 A.L.R. 446 at 448.

In *Lassen Lumber and Box Co,* supra, the taxpayer had been engaged in the logging and lumber business in California and in connection therewith had acquired a timber

contract from the United States Government allowing it to log some 26,000 acres of an adjacent forest over a period of eleven years. It proceeded to construct a sawmill near the forest, using in the main second hand equipment. In preparing its income tax return, the taxpayer based its estimate of the useful life of its mill assets on the 11 year period of its contract. The Commissioner, on the other hand, determined that the taxpayer's sawmill and logging equipment should be depreciated over the period of their longer physical useful life.

Upon the evidence adduced at the trial, the Board of Tax Appeals found that the physical useful life of portions of the taxpayer's plant was 10 years or less, on other portions 15 years and on the remainder 20 years. The Board also found that the stumpage on the 26,000 acres exceeded the amount estimated and that because of this fact the taxpayer could have confidently expected an extension, if desired, of the 11 year contract. In actual fact, the contract was extended for a period of 8½ years or for a total of 19½ years in all. In addition, the Board found that there was a considerable supply of privately owned logs and timber which was available to the taxpayer, and that the taxpayer had, in the year just prior to the hearing, actually purchased substantial quantities of such timber. Also, additional government timber was available within a reasonable distance of taxpayer's sawmill.

Based on this evidence the Board of Tax Appeals upheld the Commissioner's determination as to the useful life of the taxpayer's depreciable assets. The Court of Ap-

peals affirmed, holding that the conclusion of the Board was not without reasonable basis. In so doing, it determined that the burden of proof was on the taxpayer to establish with a reasonable degree of certainty that its plant would be useless at the end of the original contract period. In this regard, the Court's opinion states as follows:

> "We do not think it was error for the Board to hold that before the loss could be so spread, it must appear to a practical certainty that the plant would be useless at the end of the period. . . . While upon the assumption that the loss will, in fact, be incurred, it is but fair to spread it ratively over the entire period. It is also only fair to require that it be shown by a preponderance of proof that its occurrence in the future is reasonably or practically certain to take place. A possibility or mere probability is not enough. It is not a case where we may apply the law of averages, based upon wide experience under similar conditions. Upon the facts of a special case we are asked to forecast a future for 10 years and this we ought not to do, where it is possible at a later date to correct a mistake and avoid substantial injustice therefrom by appropriate adjustments, unless the happening of the contingency is reasonably certain to occur. . . ." *Lassen Lumber and Box Co. v. Blair*, supra, 19-20.

The Taxpayer in the instant case in no way disagrees with the decision of the Court of Appeals in the *Lassen Lumber and Box Co.* case. Certainly there was ample evidence in the record to overcome the taxpayer's contention in that case that its sawmill and logging equipment would lack an economic use at the end of the 11 year contract period and that, consequently, the useful life of its depreciable assets should have been determined upon the

basis of economic rather than physical factors. As mentioned above, the Board of Tax Appeals had found that the taxpayer could have confidently expected an extension of the length of its contract, if needed, and even if such extension had not been granted there was a considerable supply of privately owned timber and additional government owned timber which would have been available to it within a reasonable distance of its plant. In short, there was a secondary use for the taxpayer's sawmill following the completion of its initial 11 year contract. Similarly, in *Gordon Lubricating Co.,* supra, there was considerable evidence to support the Government's contention that a commercial or secondary use existed for the taxpayer's deep water terminal facility following the term of its then existing contract. Consequently, even if such contract were not renewed the taxpayer would still have had a continuing use for its property.

The factual situation in the instant case is quite different. Not only was the Court below called upon to render its decision before it could determine whether or not the Air Force would exercise one or more of its two remaining five years renewal options, compare *Lassen Lumber and Box Co. supra* with *Birmingham News Co. v. Patterson, supra,* but more importantly the parties stipulated that the Taxpayer's fuel storage facility would have no commercial use upon termination of use by the Government (I-R.27) (11-R. 100). Consequently, it is not possible to excuse as harmless error, as was done in *Stateline and S. R. Co. v. Phillips,* 98 F.2d 651 (C.A. 3, 1938); 120 A.L.R. 441, the

use by the lower Court of a burden of proof test based upon reasonable certainty rather than a mere preponderance of the evidence.

One final point requires mention. The opinion of the Court of Appeals in *Lassen Lumber and Box Co. v. Blair, supra,* was rendered in 1928. This was some three years prior to the publication of the opinion of the United States Supreme Court in *Burnett v. Niagara Falls Brewing Co.,* supra. This time difference has led at least one periodical to conclude that the "reasonable certainty" test mentioned in the *Lassen Lumber and Box Co.* case had been rejected in favor of the more common "mere preponderance of the evidence" test. See 120 A.L.R. 446 at 448. In fact, as implied earlier, the Court of Appeals for the Ninth Circuit, without mentioning its earlier decision in *Lassen Lumber and Box Co.* supra, has held that a taxpayer is not required to prove obsolescence "to a mathematical certainty." *Moise v. Burnett, supra.* In so doing, it cited the *Niagara Falls Brewing Co.* case with approval.

C. TAXPAYER'S BURDEN OF PROOF.

Taxpayer-Appellant is frank to concede that the Commissioner's determination of the useful life of its fuel storage facility is presumptively correct, and that the burden rests with it to prove that the Commissioner's determination of useful life is erroneous. Likewise, both the Government and the Taxpayer now agree that such proof must consist of facts known, or reasonable knowable, by the taxpayer at the end of the year for which the depreciation deduction was taken.

The Supreme Court has stated that the useful life of an asset is "the number of years the asset is expected to function profitably in use" *Massey Motors, Inc. v. United States,* 364 U.S. 92 (1960). This test logically assumes that when an asset can no longer be profitably used by its owner it will be disposed of. Thus, while the physical life of an asset is one of the factors which will be considered in determining its economic life, this factor cannot be used as the sole criterion in determining useful life for depreciation purposes where it is shown that the asset will have a shorter economic life than physical life. *M. Pauline Casey v. Commissioner,* 38 T.C. 357, at 381 (1962). See also *E. A. Vaughey,* 24 T.C.M. 1369, (1965).

The basis and justification for taxpayer's original estimate of useful life, and the basis and justification for the testimony and other evidence presented to the lower Court in this case was that the experience of its officers with similar fuel storage facilities was the best and most reliable evidence of useful life that was available to it. Certainly, as to this point the Commissioner's own regulations would so indicate. Treas. Reg. 1.167(a)-1(b) (26 C.F.R. 1.167)

The Government's theory of the case is different. Its position is that Taxpayer's fuel storage facility was tied so closely to the Grand Forks Air Force Base that what was needed was expert testimony concerning the probable useful life of the base itself. (II-R.26-27, 90-93). While Taxpayer's principal witness was familiar with the Grand Forks Air Force Base and the activities being conducted there, he did not attempt to qualify as an expert capable

of evaluating exactly how long that base would remain in use. (II-R.92). He did seek to explain, however, just why it was that he and Mr. Clack had utilized a five-year estimate of useful life for taxpayer's fuel storage facility and why such estimate was a reasonable one. For example, Mr. Davis was quick to point out that under normal circumstances Taxpayer's fuel storage facility would have had very little value as a commercial fuel storage facility after the initial five year contract period since it seemed probable that the Grand Forks Air Force Base would require either less fuel or an entirely different type of fuel for its activities following the completion of such term. As to the latter assumption, there was the expectation that the B-52 bomber would be replaced by the so-called B-70 "Chemical fuel bomber" (II-R.102-103), and as to the former assumption there was the realization that the Great Lakes Pipeline Company, sitting as it was only one mile away from Taxpayer's facility in a market area that was experiencing decreasing commercial usage, could easily and more competitively service the Base. (II-R, 93, 112) Finally, as explained by Mr. Clack, there was the generally prevalent feeling that the inter-continental missle system then being planned for installation near Grand Forks, North Dakota, would hasten the phasing out process inherent in the B-52 bomber (II-R.200-206). These factors, together with the experience gained by taxpayer's officers in dealing with the Government in regard to similar contracts, and the very language of Negotiated Contract ASP-17894, quite understandably resulted in the Taxpayer es-

timating the useful life of its fuel storage facility at five years.

The Tax Court of the United States has correctly stated that

> "Inasmuch as the determination of useful life is a question of fact taking into consideration many factors, we must necessarily rely, in addition to any other relevant evidence, upon the estimates testified to by those who are personally familiar with the assets and are qualified to give an expert opinion as to their approximate useful life" *M. Pauline Casey, supra,* at 381.

The testimony of Taxpayer's officers and the other evidence adduced at the trial of the instant case meets the abovementioned standard and such evidence, in the absence of contraverting evidence from the Government's own witnesses, was more than sufficient to carry the Taxpayer's burden of proof. See *John Paul Riddell,* 12 T.C.M. 44 (1953).

D. CONCLUSION.

The issue before the Court was one of whether or not the Taxpayer, at the end of 1960, could reasonably have expected the Government to exercise its option to renew its fuel storage contract for one or more of its three remaining five year renewal periods, and, if so, for what length of time. It is submitted that in this age of political turmoil and of constantly changing methods of military preparedness, the Taxpayer acted both reasonably and prudently in estimating the life of its Grand Forks Fuel Storage facility

at five years. Certainly the history of other such facilities as well as the history of the B-52 bomber and the Government's missle programs indicate how tenuous any other estimate would have been. The District Court erred in failing to find that the Taxpayer's estimate of useful life was reasonable and its decision should therefore be reversed and the case remanded for entry of judgment in favor of the Taxpayer-Appellant. In the alternative, the decision of the District Court should be reversed and the case remanded for new findings of fact based upon the evidence known to or knowable by, the Taxpayer as at the end of 1960.

Respectfully submitted,

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CERTIFICATE

I certify that in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing Brief is in full compliance with those rules.

DATED this 26th day of June, 1968.

Scott B. Lukins

Scott B. Lukins